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SUBJECT: EMBRACING THE DRAGON: THE PHILIPPINES DEEPENS
ECONOMIC ENGAGEMENT WITH CHINA

REF: MANILA 1954

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Summary

1. (SBU) With the visit of Chinese President Hu Jintao, the Philippines has taken stock of its expanding economic relationship with China and deepened its relationship with its dominant neighbor with respect to investment, trade and economic assistance. The glow of bilateral friendship encouraged a degree of hype, of course, and the impressive aid and investment levels totaling over \$2 billion in official pronouncements included a good dose of recycled commitments, untapped loan facilities and investment commitments in the mining sector that face serious political hurdles if implemented. At present, the PRC absorbs about 7% of Philippine exports, a fast growing but smaller share than that of the U.S. (18%) or Japan (19%). The Greater China market, including Hong Kong and Taiwan, absorbs 21% of all Philippine exports and has collectively become the country's largest export market. The "Greater China" concept, however, tends to exaggerate perceptions of the PRC's economic engagement here. Many companies, especially those run by Filipinos with Chinese ancestry, have set up operations in China, and the Philippines anticipates increased Chinese commercial investments that will further strengthen ties. That said, small- and medium-sized manufacturers and labor unions remain especially concerned about the future impact of China's export competitiveness and labor resources.

Shared History and Ethnic Connections

2. (SBU) Over the weekend prior to the Hu visit, street crews have lined Roxas Boulevard, one of Manila's main streets, with posters bearing an image of intertwined Chinese and Philippine flags and the slogan "A New Golden Age of Partnership." The proximity of the two countries, their historical connections, and the increasing prominence of Filipinos of Chinese descent within Philippine society makes the development of a strong relationship between China and the Philippines a logical and pragmatic move. Last week's visit of Chinese President Hu Jintao April 26-28 coincided with the 30th anniversary of the diplomatic relationship between the Philippines and China. Their economic relationship, however, has a much longer history, and recent scholarship substantiates a significant, though not continuous, trade and commercial relationship back as far as the seventh century.

3. (SBU) Xiao Qian, DCM at the PRC Embassy, emphasized to us that the most important substantive aspect of the visit was on the economic and trade side. As China has emerged as a major economic power in Asia, the Philippines has recognized that it could stand to reap significant benefits from developing a closer trade relationship with China and attracting Chinese investments. At the same time, the threat of increasing Chinese competitiveness, the relatively cheap and unorganized labor it offers, and the prospect of diverted foreign direct investment causes many Filipinos to take a more cautious stance towards the possibility of closer engagement.

Expanding Trade Relations

4. (SBU) Trade relations between China and the Philippines have been growing at a more rapid pace since China's accession to the WTO. Data from the Philippine National Statistics Office (NSO) reveals that Philippine exports to China increased by 71% in 2002, 58% in 2003, and 24% in 2004. This growth is markedly higher than the growth experience by Philippine exports to the world as a whole (which increased only by 10% in 2002, 3% in 2003, and 9% in 2004.) It is also much higher than the growth rate of Philippine exports to

China prior to 2001. A 2004 study conducted by the Philippine Institute for Development Studies reveals that total exports from the Philippines to China grew at an average of 13.5% over 1980-1996. China's accession to the WTO in 2001 and its subsequent actions to liberalize its markets has been one of the driving forces behind this dramatic growth in Philippine exports. The PRC absorbs about 7% of Philippine exports, a fast growing but smaller share than that of the U.S. (18%) or Japan (19%). The Greater China market, including Hong Kong and Taiwan, however, now absorbs 21% of all Philippine exports, and these economies have collectively become the country's largest export market, so the "China market" for Filipinos is significantly much more than that of the PRC. The Greater China concept, of course, tends to exaggerate the PRC's economic engagement here. Major Philippine exports to China include semi-conductor devices, electronic data processing units, office equipment, consumer electronics, and fresh fruit.

15. (SBU) Imports from China have also increased dramatically. Inbound shipments from China only reached \$294 million in 1994, or 1% of all Philippine imports. In 2004, China accounted for \$2.533 billion, or 6.3% of its imports, compared to the U.S. share of 16%. Philippine imports from China include semiconductors, textiles, petroleum products, metal-based construction materials, iron and steel. The high degree of intra-industry trade in this bilateral relationship threatens many Philippine manufacturers and exporters. Philippine businesses and labor unions remain concerned about China's growing export competitiveness and large labor market. Big business, especially firms headed up by Chinese-Filipinos, can cope with competition through investments in China, but smaller firms, which make up the bulk of manufacturers here, will face difficult adjustments in the years ahead.

Smuggling: Invisible Imports Distort Trade Data

16. (SBU) During Hu Jintao's visit, both sides set targets of \$20 billion in bilateral trade in the next two years and \$30 billion by 2010. The trade numbers put out by the National Statistics Office of the Philippine Government, however, do not tell the whole story of Philippine-Chinese trade. Many of the goods from China entering the Philippines arrive in clandestine shipments and are not incorporated into the official statistics. The Website of the Philippine Embassy in Beijing draws on data from China's General Administration of Customs to list the volume of 2004 bilateral trade at \$13.3 billion, more than double the \$5.185 billion cited by the RP's National Statistics Office. This discrepancy between the data collected by the Chinese and Philippine governments suggests that a great deal of the trade between these two countries is happening under the radar.8 The Philippine press has recently carried stories about local producers of shoes, textiles, and appliances that have been negatively affected by the large-scale smuggling of Chinese goods. China is the source of a number of IPR-infringing items such as DVDs and designer knock-offs that line the stalls of some of Metro Manila's largest shopping districts. Not all pirated goods on the Philippine market need to be smuggled in from China to make their way onto store shelves. On April 1, Philippine police raided a plant producing 300,000 pirated optical disks per day and arrested 11 undocumented aliens (it remains unclear whether they are Taiwanese or PRC nationals) who had staffed the operation.

Agricultural Trade Remains a Sensitive Issue

17. (SBU) The Philippines enjoys a small trade surplus in its trade relationship with China, although it has a deficit of \$100 million in agricultural trade. But if anecdotal accounts of rampant smuggling of goods from China are accurate, the Philippines may actually be running a significant trade deficit. Agricultural issues have figured prominently in the bilateral trade relationship, despite the fact that agriculture represents an increasingly small proportion of their bilateral trade relationship (electronics now make up more than half of all goods exchanged.) One of the major concessions8 the PRC had made during Hu Jintao visit, Xiao Qian said, was on the Early Harvest program,8 a trading protocol between ASEAN Member States. The PRC will now allow Philippine agricultural exports similarly concessional status as it already affords Cambodia, Laos, and Vietnam. Qian indicated that these three countries would likely be unhappy with the inclusion of the more developed Philippines, but that the GRP had pushed hard on this issue.

18. (SBU) The two governments also signed a Memorandum of Understanding that will allocate, on a country-specific basis, 25 KMT of rice to China in compliance with the Philippines minimum access obligations under its WTO

accession agreement. This MOU represents approval by China, as one of nine challenging WTO member countries, of the request by the Philippines for extension of its special treatment for rice under Annex 5 of the WTO Agreement on Agriculture. That is, for certain concessions, e.g., those contained in this bilateral MOU, China agrees to allow the GRP to continue to maintain quantitative restrictions on rice for an additional seven years.

Taipans Invest in the Chinese Market

19. (SBU) Although Chinese merchants have long dominated the business community in the Philippines, they were historically isolated from mainstream Filipino society and barred from obtaining Filipino citizenship. Most Chinese Filipinos migrated from the provinces of Fujian and Guangdong in Southern China, and have maintained strong trade connections with these two provinces. The emergence of a class of wealthy and powerful Chinese-Filipinos known as Taipans (most notably Lucio Tan and John Gokongwei) who exercise considerable influence over business has changed the role of the Chinese community within the Philippines. Although these families lack the bloodlines that would prime their children for entrance into politics, they are able to wield significant power over political decisions through their hefty political contributions. These wealthy Chinese-Filipino families have recently begun to re-discover the potential gains associated with their connections to China, and have begun to make investments in China itself. These investors have historical ties to China, speak Chinese, and have, for the most part, been successful in their business endeavors there. Their increasing focus on mainland China for their investments reflects an economic move away from Taiwan and towards the PRC.

10. (U) Mr. Carlos Chan was one of the first Filipinos of Chinese origin to expand successfully into the Chinese market. Mr. Chan began operations for his company, Liwayway Food Enterprises, in 1993 and now has approximately \$250 million in yearly sales. Other Filipinos of Chinese origin have followed Mr. Chan's lead, notably his brother Ben Chan, the founder and chairman of Bench, the popular clothing brand, which has established a 8 stores in China as well as Lucio Tan who has recently purchased a 25,000 square meter plot of land to construct a hotel and department store. This trend of Filipino-Chinese-owned businesses looking to China for investments is likely to continue and become even more significant. Filipinos of non-Chinese origins have also begun to recognize China as a business opportunity. Pacita Juan, founder of Figaro Coffee Company, a local brand that has set up its first franchises in China, found that hiring a good translator was key to her success in her business endeavor. She responded to the allegation that Filipinos investing in China will abandon their home country, assuring &(we can be successful and repatriate the profits.8

Investment and Economic Assistance:Hype Tempered with Goodwill

11. (SBU) China's economic growth has positioned more of its companies to invest abroad, although its investments in the Philippines thus far remain limited (accounting for only 0.1% of total approved FDIs in the Philippines in 2004, according to a study released by the Economist Corporate Network in 2005), many hope that Hu Jintao's visit will spark further Chinese investor interest in the area. According to Xiao Qian, the visit produced 15 agreements on various trade and investment deals. One agreement commits approximately \$800 million to reopen an existing nickel mine, which would represent the largest foreign mining investment in the country since the Supreme Court's recent decision to open the mining industry to foreign investment. Another agreement offers a "new tranche" of long-term, low interest credit worth \$500 million for the Northern Railway project (in addition to an existing \$400 credit that has not yet been touched.) This project will build only 82 kilometers of railway, Qian admitted, citing the need for numerous bridges and flyovers as a reason for the high cost. He also noted problems that GRP had faced in removing residents and squatters; so far the GRP had cleared only 7 kilometers of the route, but the GRP had assured the PRC that this was the most complex stretch, and the rest would go quickly. Qian stated that the PRC planned to use mostly Chinese equipment in the new construction but indicated the &possibility8 of using local laborers. Another high profile deal will involve replacing an existing French-style cell phone system (which may be relocated in North Luzon) with a Chinese-build US-style system.

12. (SBU) In the context of the Hu visit, the two governments, of course, tended to hype potential Chinese investments and economic assistance. The two sides highlighted the Luzon railway project during GMS's fall, 2004

visit to Beijing and the announcements appear to be recycled commitments for a project that has had a very slow start with almost no disbursements of funds from these Chinese loan facilities. The mining sector investment in nickel appears significant on the surface but, again, the Chinese have not disbursed funds and mining investments here are still subject to many local government and other constraints.

13. (SBU) Ambassador Jose Antonio, Philippine Special Envoy to the People's Republic of China, has stated that medical tourism, infrastructure, mining, and pharmaceutical represented areas for potential Chinese investment in the Philippines. Despite the positive tone of Antonio's remarks, and the energy surrounding the visit of President Hu Jintao, many Filipinos (especially those in the shoe, garment, and agricultural businesses) remain apprehensive that Chinese success in drawing foreign investment will displace money that might have otherwise been invested in the Philippines. Ambassador Antonio dismissed these fears, summing them up as &fear of the unknown and fear of the Chinese as traders,⁸ that would be alleviated once Filipinos recognized the benefits of closer engagement with China.

Comment

14. As China continues to act as a growth-driver for the Asia-Pacific region, and as its increasing domestic demand transforms it into a consumer society in its own right, the Philippines is unlikely to step away from the closer relationship it has developed with its powerful neighbor. As China offers more foreign aid to the Philippines and becomes an increasingly large market for Philippine goods, the relationship between the two countries is likely to deepen economically and may extend to cooperation in other areas (reftel). Chinese influence in the Philippines is set to grow, and, as China's production capabilities increase, its exports to the Philippines, both legal and illegal, are also likely to grow. Filipinos, while viewing China as a competitor for market access opportunities as well as for FDI inflows, will also increasingly recognize China as an important economic partner.
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